Statement Of
The Honorable James L. Oberstar
Committee on Transportation & Infrastructure
Hearing On
"Rail Competition and Service"
September 25, 2007

October 14 marks the twenty-seventh anniversary of passage of the Staggers Rail Act. In this single generation, the rail industry has transformed into something that is almost unrecognizable to what it was before Staggers. For example, there were 40 Class I railroads in 1980, and today there are 7 Class I railroads. The U.S. freight rail network encompassed 178,000 route miles in 1980, while today, due to line abandonments and spin-offs to short lines, that number has fallen 21% to 140,810 route miles. The railroads' fortunes have also enjoyed a dramatic turnaround. Many railroads stood on the precipice of bankruptcy immediately prior to Staggers, in stark contrast to their financial health today. In the last ten years alone, the combined net income of the seven Class I railroads has increased over 104% from 1996 to 2006, from $3.7 billion to $7.6 billion.

The railroad industry has changed in other ways, too. While on paper there are seven Class I railroads, in reality the railroad industry has consolidated and evolved into two regional duopolies, one in the east made up of CSX and Norfolk Southern, and one in the west made up of Union Pacific and BNSF.

In a duopoly market, shippers with access to two rail carriers may often encounter rates closer to that of a captive shipper. The rail carriers can tacitly coordinate their activities simply by observing each other's historical bidding behavior, gauging the market demand for different prices, estimating each other's cost structures and making some assumptions about what prices would earn the most long-term profit, given the trade-off between price and volume demanded. Despite the temptation to undercut each other's price to seize market share, neither railroad may bid a competitive rate, leaving a shipper in the predicament of facing two relatively high bids. These activities are not always instances of illegal collusion. However, it does take away the shipper's opportunity for real competition.

Further, a shipper operating in a duopoly market is often like a captive shipper, in that a railroad will often enjoy greater opportunities to assign costs onto a shipper that has little to do with the actual cost of service. A 2006 report by the Government Accountability Office (GAO) found that railroads are increasingly transferring additional costs onto shippers that are not reflected in their rates. Since 1985, rail car ownership has shifted nearly 20 percent to shippers so that today shippers own a majority of rail cars in use. The GAO also found that shippers are paying other costs such as infrastructure upgrades, fuel surcharges, and congestion fees. Unfortunately, the Surface Transportation Board (STB or Board) does not track these charges, leading the GAO to conclude that shippers in such markets may be paying excessive rates for rail service.

But the railroads contend that the system works, and addressing any shortfalls in the system will lead to unacceptable reductions in their revenue and a sharp decrease in capital investment. They contend that despite the benefits of the Staggers Act, they are still struggling to arrive at financial health, reflected by the STB's current analysis that the industry as a whole is “revenue inadequate.” Indeed, since passage of Staggers, the Interstate Commerce Commission (ICC) and now the Board have made 445 findings of revenue adequacy for railroad companies. They found railroads to be revenue adequate in just 32 instances, in which just over half were for two companies, the Illinois Central (now part of Canadian National) and Norfolk Southern. Otherwise, Union Pacific had one finding of revenue adequacy in 27 years, CSX was revenue adequate three times, and the BNSF had four findings of revenue adequacy. Since the Staggers Act, the railroad industry as a whole has never been found to be revenue adequate, and the railroad association reports that since the Staggers Act, the difference between the industry’s return on investment and its cost of capital has not substantially narrowed.

What should follow from such a record would be significant capital shortages and even disinvestment in the rail industry. According to the ICC’s 1981 decision implementing the current revenue adequacy test, “any firm that earns less than its cost of capital will be unable to compete in the market for funds. Its owners will neither wish nor be able to keep the enterprise’s capital intact. They will withdraw their capital as quickly and as expeditiously as they can.” But the railroads continue to secure capital from Wall Street, earn substantial profits, and invest billions of dollars in their systems, despite the constant shortfall of meeting the regulatory standard for revenue adequacy.

This discrepancy between the railroads’ reports of revenue shortfalls and the continued availability of investment capital is understandable if you examine the current regulatory method used to determine the railroads’ revenue adequacy. While there are many methods to determine revenue adequacy, the model implemented in 1981 fell out of favor with Wall Street some time ago. Wall Street views it as overly pessimistic of the railroads’ cost of capital and their financial health. For example, in 1995 and again in 1999, *Standard & Poor’s Industry Surveys* reported that the rail industry “is actually fit as a fiddle,” and explained that the ICC’s definition of cost of capital was “not particularly meaningful given the many flaws in the design of its financial test.” Additionally, when Wall Street measures the revenue adequacy of an investment, it uses a newer and more accurate tool to measure revenue adequacy, the Capital Asset Pricing Model, also used by the Canadian counterpart to the Board. According to Wall Street, the railroads are financially healthier than reported by the STB. In fact, the STB recently announced it was updating its revenue adequacy methodology to reflect Wall Street’s methodology.

Further, Wall Street has a very positive outlook for the railroads. Morgan Stanley reports that the five U.S.-based railroads, Union Pacific, BNSF, CSX, Norfolk Southern, and Kansas City Southern still have 10-35% of their legacy contracts in place. Railroads sought out legacy contracts when they were not financially healthy, locking in business over a longer time at lower rates. Today, railroads are signing much shorter service contracts with their customers, in order to take advantage of the greater price control they have over the market. As these older legacy contracts come due, these customers will sign shorter contracts at higher rates with escalation clauses. Morgan Stanley predicts that this will drive up revenue 15 to 20% through 2010 on these legacy customers alone.

But any economist will tell you that for regulatory purposes it is better for the railroads’ profits to remain revenue inadequate. This grants them a favorable regulatory environment from the Board, which allows them to charge higher rates to their captive customers without coming under threat of an adverse rate decision. For example, if a captive rail customer disputes a rail carrier's rate with the Board, the Board will determine if the rate is reasonable using the "constrained market pricing," or CMP, model established by the ICC in 1985. CMP is designed to set reasonable prices for revenue inadequate railroads, meaning that the Board assumes it costs more to provide service to a customer because the railroad is not receiving an adequate return on capital. If a railroad is revenue adequate, the rate should be lower. However, the ICC did not design CMP to remain in place once the railroads returned to health. When the ICC developed CMP, it stated "captive shippers should not be required to continue to pay differentially higher rates than other shippers when some or all of that differential is no longer necessary to ensure a financially sound carrier capable of meeting its current and future service needs." While it is uncertain what pricing structure the ICC envisioned, it seems clear that when the ICC created the current pricing framework, the expectation was that there would be significant adjustments when revenue adequacy is achieved.

While the railroads' financial health continues to improve and their pricing power increases, the current regulatory environment still reflects an industry closer in health to what existed prior to passage of the Staggers Act. This works to the detriment of shippers seeking rate relief. When Congress passed the Staggers Act in 1980, it empowered the ICC, and its successor the STB, to protect captive shippers from unreasonable rates and granted broad authority to monitor the performance of the railroad industry.

However, shippers tell me that the Board is not effectively exercising their responsibility. The 2006 GAO report reinforces the shippers' contention, stating "there is little effective relief for captive shippers because the STB's standard rate relief process is largely inaccessible." Contesting a case is now so expensive, time consuming, and complex that only the most egregious cases have a chance to come to the Board's attention. Since 2001, shippers filed 11 CMP cases with the Board. All but one of these 11 is a coal rate dispute. Of the 11, the Board settled and dismissed three, one was withdrawn, and one is still pending. Of the remaining six, the STB issued decisions in the railroads' favor. The STB reports that these cases on average took 2.8 years to decide; shippers report that many spent upwards of $5 million to contest them. Additionally, the GAO reports that traffic traveling at rates substantially over the threshold for rate relief has increased.

That is why Ranking Member Richard Baker and I introduced H.R. 2125, the Rail Competition and Service Improvement Act. While the railroads claim that this legislation is "re-regulation," our legislation injects much-needed competition into the rail industry. Our legislation does not address any regulatory activities such as market entry or pricing. In fact, our legislation maintains the railroads right to use differential pricing for their business operations and preserve the 180% revenue to variable cost threshold before a shipper may bring a rate dispute case before the STB. The Board is not effectively meeting its responsibilities and so this legislation will ensure that it makes further efforts to improve its rate relief processes and address competition and captivity concerns.

I look forward to hearing from our witnesses today and thank you all for being here this morning.

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